The Financial Navigator – August Newsletter

With all the news and discussion of the U.S. debt level, and the recent downgrade of Uncle Sam by S&P, we thought it might be interesting to discuss stock market returns of countries that have high debt levels to add a little historical perspective to the discussion. One might assume there is a direct correlation between a country's fiscal health and the performance of its stock market. There may be, but it could be the inverse of what one might expect. Stock markets in countries that are nearly bankrupt don't necessarily produce negative returns, in fact it can be quite the opposite, which may be worth pondering as you consider your future investments in U.S. or European based markets.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Government Debt and the Stock Market Investor

Last week we came across an "Economic and Policy Watch" update prepared by a major investment bank that reviewed recent government proposals to address the nation's funding crisis. Titled "It Just Gets Worse," the report chided policymakers for actions that "look like a poor cover for loose money, rising inflation, and fiscal problems," and warned that "government financing needs are corrupting monetary policy." As a result of these ill-advised tactics, the bank had turned "more negative" on the outlook for financial stability and saw "little hope of improvement in the inflation/currency mix."

Amidst the barrage of news coverage from dozens of sources probing the US debt/default/downgrade issue, such a conclusion might seem unremarkable. We found it of interest because the focus of the report was not the US Treasury but the government of Indonesia, and it appeared over a decade ago, on July 16, 2001.

Indonesia's sovereign debt rating at that time placed it firmly in the "junk" (non-investment grade) category: B3 from Moody's and single-B from Standard & Poor's. Although Moody's upgraded Indonesia to a B2 rating in 2003 and to Ba1 in early 2011, at no time over the past decade was Indonesia deemed to merit an investment grade rating.

What has been the experience of stock investors in Indonesia since this report was published? The Jakarta Composite Index closed at 415.09 on January 16, 2001, while the Dow Jones Industrial Average finished that day at 10,652.66. On Wednesday, the Jakarta Composite closed at 4,087.09 and the Dow at 12,592.80. If the Dow Jones Average had kept pace with Indonesian stocks over the past decade, it would be over 104,000 today.

Investors in Indonesia have had their share of ups and downs over the years, and markets fell even harder than the US during the financial crisis, with a peak-to-trough loss of nearly 60%. But the recovery was sharper as well: The Jakarta Composite recouped all of its losses by April 2010, and the all-time high on July 22 this year was 45% above the high-water mark of early 2008.

At no point throughout this period did Indonesia have an investment grade rating for its sovereign debt, and outside observers continue to find fault with the country's troublesome level of corruption, primitive infrastructure, and unpredictable regulatory apparatus.

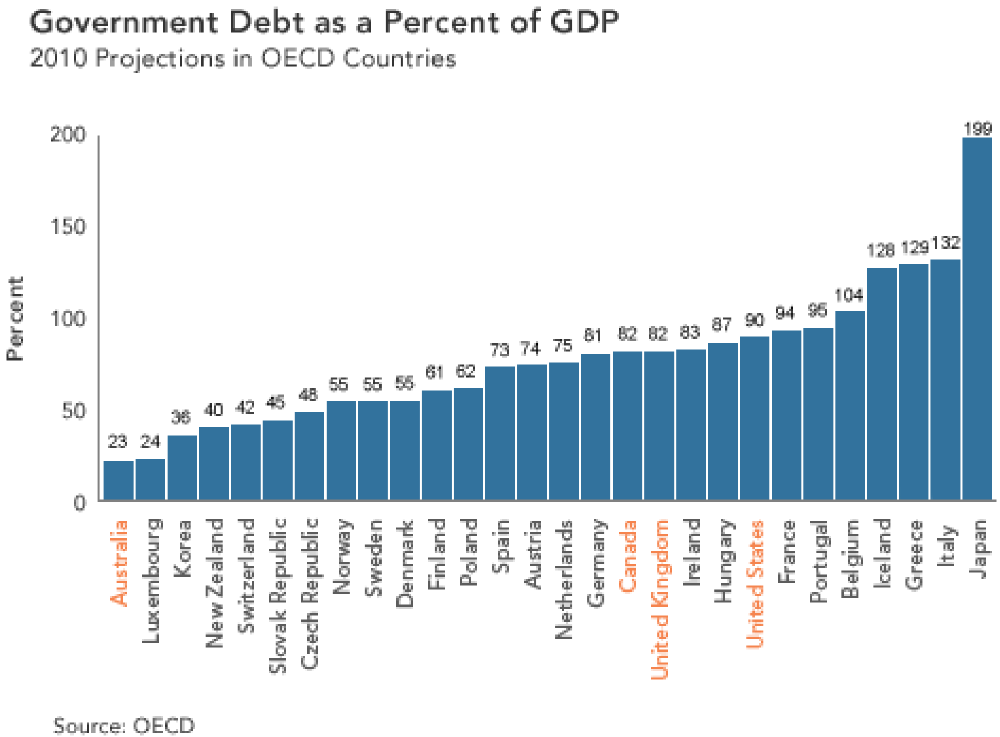
We are not suggesting that investors should dismiss the effects of a US government credit downgrade. US Treasury securities are so widely held around the world that any potentially destabilizing event is worrisome. Nor are we suggesting that investors focus solely on countries with low credit ratings. Just as a broadly diversified portfolio includes *companies* with high and low credit quality, investing in *countries* with both high and low ratings is equally sensible.

Our point is that a low credit rating in and of itself is not necessarily a death sentence for equity investors. Citizens of triple-A countries behave much like those living in single-B territory—they eat, drink, shop, get stuck in traffic jams, chatter on mobile phones, and check their Facebook pages. (Indonesia claims the second-largest number of Facebook members in the world.) Companies doing business in either location generate cash flows, and investors do their best to evaluate what those cash flows are worth. A triple-A government debt rating is no guarantee of superior equity market returns, and a "junk" rating is no assurance of failure. A diversified strategy will have exposure to both.

Debts, Deficits, and Markets

As government spending hits record levels around the globe, some politicians, economists, and pundits are warning that rising indebtedness may drag down economies and financial markets. This issue has raised concern among investors who assume that a government's fiscal policy is closely linked to the country's economic growth and market returns.

The graph below shows the projected state of indebtedness around the world.[6] Over half the Organization of Economic Co-operation and Development (OECD) member countries expect to have debt-to-Gross Domestic Product (GDP) levels above 70%—and the US, Canada, and the UK project debt levels exceeding 80% of their economic output.



Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions, and rising health care obligations are compounding the fiscal challenges of these countries.

Global investors may be particularly concerned about the economics of government spending in countries around the world. So how does public debt affect economic growth and market returns? The evidence might surprise you. Although rising levels of government debt create headwinds for economic growth, a country's deficit and debt levels do not seem to adversely impact stock market returns.

Let's explore these issues by addressing a few popular questions about government debt:

Do rising deficits drive up interest rates?

Yes. As borrowing increases, a government must offer higher interest rates on its debt to compete for capital. The public sector consumes savings and investment that may have otherwise fueled private sector growth—a displacement of resources known as the "crowding out effect" in economic theory. Additionally, as debt levels rise, market concerns about higher default and inflation risks put additional upward pressure on interest rates.

Do higher deficits hamper economic growth?

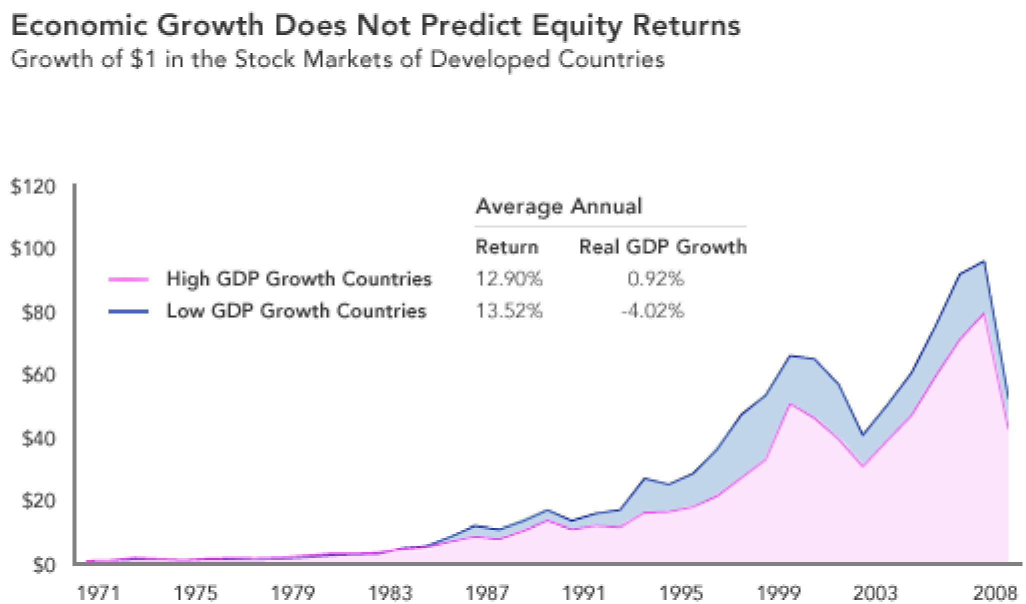
It depends on a country's debt level. Using World Bank data from 1991 to 2008, we compared current deficits to future GDP growth in sixty-seven countries and found an increasing interactive effect between deficits, debt, and economic growth. High-debt countries that run deficits are more likely to experience lower economic growth over the next three years. But numerous forces may affect a country's economic direction, and deficits explain only a small fraction of the variation in future GDP growth. The combination of high debt and deficits can create headwinds for economic expansion, but slower growth is not guaranteed.

So investors are justified in having some economic concern about higher government spending and borrowing. But the impact on investment returns is less clear. Let's now consider the potential effect on equity markets.

Does low economic growth result in diminished equity returns?

No. This relationship can be tested by comparing a country's GDP growth to its equity market performance in subsequent years. We conducted this analysis using all the developed countries in the world stock market universe, divided each year into high-growth and low-growth "portfolios" based on growth in real GDP. There was no statistical difference between the annual returns of equity markets in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average returns than high-growth countries.

The graph below illustrates this relationship in terms of a dollar invested in high- versus low-GDP growth portfolios from 1971 to 2008. The low-GDP growth portfolio's higher annual return would have generated slightly more wealth for the period. The chart details the average annual return and real GDP growth for both groups.



Source: MSCI

Applying the same methodology to the emerging market countries shows an even greater return difference, although the data period is much shorter (2001 to 2008). The return of the high-growth country portfolio averaged 19.77% (with 2.5% GDP growth), versus 24.62% for the low-growth portfolio (-4.94% GDP growth).

Other research has confirmed a weak relationship between a country's economic growth and its stock market returns.[7] Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company's stock price in its home market may not reflect economic conditions in other countries. Also, the fruits of economic growth do not accrue exclusively to public companies, but also to income earners, non-public businesses, and private investments.

Finally, consider that risk, not economic growth, determines a stock's expected return. Research indicates that this principle also applies to a country's stock market.[8] Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns. Consequently, while holding a "growth market" may be a rational investment approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

Do fiscal deficits lead to currency depreciation?

No. It is commonly believed that large fiscal deficits and high debt cause a currency to depreciate as the government borrows more from foreign sources, and investors who are concerned about inflation and default risk flee the currency. Although recent developments in the US would seem to support this relationship, there is less convincing long-term evidence that deficits affect currency rates. During the 1970s and 1980s, the dollar strengthened while the government increased deficit spending.[9] This observation is consistent with academic studies concluding that exchange rates appear to move randomly, and there are no models to date that can reliably forecast currency returns.[10]

Conclusions

Some economists claim that developed market countries are moving into an era of high government deficits and lower market returns. While higher deficits and debt may impact a nation's interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country's financial markets, or anticipate short-term currency movements.

Investors should assume that stock and bond prices reflect all that is currently known and expected about government spending and debt, economic growth, risk, and other issues affecting performance.

Endnotes:

1. Credit to Weston Wellington of Dimensional Fund Advisors for the basis of first article.

2. The Organization of Economic Co-operation and Development (OECD) is an international economic organization of thirty-three countries founded in 1961 to stimulate economic progress and world trade. It defines itself as a forum of countries committed to democracy and the market economy.

3. MSCI Barra Research Bulletin, "Is There a Link Between GDP Growth and Equity Returns?" May 2010.

4. Clifford S. Assness, John M. Liew, and Ross L. Stevens, "Parallels between the Cross-Sectional Predictability of Stock and Country Returns," Journal of Business 79, no. 1 (March 1996): 429–451. Their research uncovered strong parallels between the explanatory power of aggregate book-to-market and aggregate earnings-to-price ratios for country stock markets.

5. Another common assumption is that current account deficits and currency appreciation are related. (The current account balance is the difference between a country's receipts and payments to the world. This account is composed mostly of the balance of trade, with net income and foreign aid playing a smaller role.) Academic research yields equivocal results on whether this relationship holds.

6. Richard A. Meese and Kenneth Rogoff, "Empirical exchange rate models of the seventies: Do they fit out of sample?" Journal of International Economics 14, no. 1 (February 1983): 3–24. Kenneth Rogoff and Vania Stavrakeva, "The Continuing Puzzle of Short Horizon Exchange Rate Forecasting" (National Bureau of Economic Research working paper No. 14071, June 2008).

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.